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In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES HERMAN O'HAGAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether respondent's trading of securities on material, nonpublic information that he misappropriated in breach of his fiduciary duties violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.

2. Whether the Securities and Exchange Commission validly exercised its rulemaking authority under Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(e), in promulgating Rule 14e-3, 17 C.F.R. 240.14e-3, an insider trading rule relating to tender offers.

3. Whether respondent's trading in securities on material, nonpublic information that he misappropriated in breach of his fiduciary duties violated the mail fraud statute, 18 U.S.C. 1341, even if his conduct did not violate the securities laws.

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PETITION FOR A WRIT OF CERTIORARI

The Acting Solicitor General, on behalf of the United States, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in this case.

OPINION BELOW

The opinion of the court of appeals (App. 1a-39a)[1] is reported at 92 F.3d 612. The order of the district court denying the motion to dismiss the indictment (App. 73a-74a) and the report and recommendation of the magistrate judge (App. 40a-72a) are unreported.

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[1] "App." refers to the separately bound appendix to this petition.

JURISDICTION

The judgment of the court of appeals was entered on August 2, 1996. A petition for rehearing was denied on November 13, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND RULES INVOLVED

The texts of 18 U.S.C. 1341, 15 U.S.C. 78j(b) and 78n(e), and 17 C.F.R. 240.10b-5 and 240.14e-3(a) are reproduced at App. 76a-79a.

STATEMENT

Following a jury trial in the United States District Court for the District of Minnesota, respondent was convicted on 20 counts of mail fraud (Counts 1-20), in violation of 18 U.S.C. 1341; 17 counts of securities fraud (Counts 21-37), in violation of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78j(b), and 17 C.F.R. 240.10b-5 (Rule 10b-5); 17 counts of fraudulent trading in connection with a tender offer (Counts 38-54), in violation of Section 14(e) of the Exchange Act, 15 U.S.C. 78n(e), and 17 C.F.R. 240.14e-3(a) (Rule 14e-3(a)); one count of engaging in a monetary transaction in property derived from an unlawful activity (Count 55), in violation of 18 U.S.C. 1957; and two counts of money laundering (Counts 56-57), in violation of 18 U.S.C. 1956(a)(1)(B)(i). Respondent was sentenced to 41 months' imprisonment, to be followed by three years of supervised release, and was fined $150,000. The court of appeals reversed all the convictions. App. 1a-39a.

1. Respondent was a partner in the law firm of Dorsey & Whitney, located in Minneapolis, Minnesota. App. 2a. In October 1986, a Dorsey & Whitney

client, Northrup King, transferred $1 million to the law firm's trust account in connection with the settlement of a lawsuit handled by respondent. IIa Tr. 67-74; VI Tr. 209-210. Although that money was supposed to remain in the trust account until disbursement was made to the plaintiffs, respondent withdrew the entire $1 million through transfers to his personal bank accounts. IIa Tr. 80-81; III Tr. 26-38; GX 1.

In July 1988, the trial court presiding over the lawsuit against Northrup King ordered respondent to distribute the funds held in the trust account under the settlement agreement. To replace the funds that he had stolen from the trust account, respondent used $185,000 that he had received from two other clients to settle other cases. By the end of August 1988, however, respondent still needed more than $400,000 to pay the remaining claims under the settlement. III Tr. 37-47, 217-219.

In July 1988, Dorsey & Whitney was retained as local counsel by Grand Metropolitan PLC (Grand Met), a company based in the United Kingdom, to represent it in connection with a possible tender offer for the common stock of Pillsbury Company, a company headquartered in Minnesota. IV Tr. 8-9; V Tr. 88-89; X Tr. 44-45; XI Tr. 20-21. On August 16, 1988, the board of directors of Grand Met approved the acquisition of all of Pillsbury's outstanding common stock. Grand Met originally planned to announce the tender offer to the public before or immediately after Labor Day, but the announcement was delayed several times. App. 2a; IV Tr. 8-17; V Tr. 88-89; X Tr. 42-45.

Thomas Tinkham was the Dorsey & Whitney partner assigned to head the team of attorneys

handling litigation matters in Grand Met's acquisition of Pillsbury. He was scheduled to meet with partners from the law firm's corporate department on August 26, 1988, to discuss whether the firm should continue to represent Grand Met in its attempt to acquire a local company. A few days before that meeting, respondent stopped by Tinkham's office. Respondent told Tinkham that he understood that Tinkham was working on the Pillsbury takeover, and expressed an interest in working on the case. Although Tinkham declined respondent's offer to work on the case, Tinkham discussed Grand Met's plans to acquire Pillsbury's common stock with respondent. IV Tr. 9-10; V Tr. 40-42, 89-99.

Grand Met and Dorsey & Whitney took extensive steps to maintain the confidentiality of information about the tender offer plans. Dorsey & Whitney limited the dissemination of information to as few people as possible within the firm; the firm's file on the matter was opened under the name of Cravath, Swaine & Moore (the New York law firm retained by Grand Met), and the subject of the representation was described under the heading "general matters." V Tr. 36-40. Even within Grand Met, only seven or eight people knew the proposed offering price for Pillsbury stock. X Tr. 30. Those efforts to keep the tender offer plans confidential were largely successful; Pillsbury stock maintained a steady price before the tender offer was announced, and investors discounted, as unfounded gossip, media stories suggesting a possible takeover of Pillsbury. III Tr. 97-104, 128-129; IV Tr. 25-27, 77, 96; VI Tr. 69-77, 105-106; XI Tr. 53-57.

Several weeks after Dorsey & Whitney began representing Grand Met, respondent began buying

call options for Pillsbury stock.[2] By August 25, 1988, respondent had accumulated a total of 500 Pillsbury call options (each option giving him a right to purchase 100 shares of Pillsbury stock), with an expiration date of September 17, 1988. Because the takeover was delayed beyond those options' expiration date, respondent did not exercise those options. App. 2a-3a & n.1; V Tr. 165, 181; VI Tr. 202-203; VIII Tr. 27-28; GX 34a.

After his discussion with Tinkham, respondent accumulated additional Pillsbury call options, with later expiration dates. On August 29, 1988, he began purchasing Pillsbury call options with an expiration date of October 22, 1988. The next day, he began purchasing Pillsbury call options with an expiration date of November 19, 1988. By the end of September 1988, respondent had amassed 2,500 Pillsbury call options. He financed those purchases with $200,000 in proceeds from a bank loan secured by a mortgage on his home. Respondent also purchased 5,000 shares of Pillsbury common stock on September 10, 1988, for just under $39 per share. App. 2a-3a & n.2; VI Tr. 198-200, 202-204; VIII Tr. 31-41; GX 34a, 37a.

On October 4, 1988, Grand Met publicly announced its tender offer for Pillsbury stock. Following the announcement, the price of Pillsbury stock rose from $39 per share to nearly $60 per share. Respondent then sold all his Pillsbury call options. See V Tr. 138-139, 180-181, 184-185; VIII Tr. 38-40, 42-43. He also sold all the Pillsbury stock that he had acquired. He made a total profit of more than $4.3 million on his

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[2] A call option gives the holder the right to purchase a specified number of shares of a stock, at a set "strike" price, on or before a certain expiration date. App. 2a n.1.

Pillsbury securities. App. 3a; VI Tr. 183-190; GX 47, 78.

Respondent used his profits from the Pillsbury trades to replenish the funds he had stolen from the firm's trust account. III Tr. 47-52; V Tr. 186-188. Confirmations of respondent's trades in Pillsbury securities were mailed to him by his brokerage firm. V Tr. 188-190.

2. Respondent argued, before trial and in the court of appeals, that the indictment did not state a violation of the securities laws. He contended, among other things, that Counts 21-37, which charged him with securities fraud under Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and Securities and Exchange Commission (SEC or Commission) Rule 10b-5, 17 C.F.R. 240.10b-5, should be dismissed because those counts alleged that he had breached only a fiduciary duty owed to Dorsey & Whitney and Grand Met, and not a duty owed to Pillsbury or its shareholders. He also contended that Counts 38-54, which charged him with fraudulent trading in connection with a tender offer under Section 14(e) of the Exchange Act, 15 U.S.C. 78n(e), and SEC Rule 14e-3(a), 17 C.F.R. 240.14e-3(a), should be dismissed because the Commission had exceeded its rulemaking authority in promulgating Rule 14e-3(a). The magistrate judge and the district court rejected those contentions. App. 54a-66a, 69a-70a, 73a-74a.

3. A divided panel of the court of appeals reversed respondent's convictions on all 57 counts. App. 1a-39a.

a. The court of appeals noted that respondent's convictions under Section 10(b) and Rule 10b-5 were based solely on the misappropriation theory of securities fraud. The misappropriation theory, the court explained, "has been held to impose § 10(b) and Rule

10b-5 liability for fraud on an individual who (1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock." App. 9a (internal quotation marks omitted). Specifically, the court noted, respondent was alleged to have "breached a fiduciary duty to Dorsey & Whitney and Grand Met when, through his employment at Dorsey & Whitney, he obtained confidential, material, and nonpublic information concerning Grand Met's interest in acquiring Pillsbury, and subsequently used that information as a basis for trading in Pillsbury securities." *Id.* at 10a.

The court of appeals held that the misappropriation theory is not a valid basis for liability under Section 10(b) and Rule 10b-5, and it rejected contrary decisions of the Second, Seventh, and Ninth Circuits sustaining, and the Third Circuit discussing favorably, the misappropriation theory. App. 11a-24a. The court stated that the misappropriation theory does not require "deception," in that it "permits the imposition of § 10(b) liability based upon the mere breach of a fiduciary duty without a particularized showing of misrepresentation or nondisclosure," *id.* at 12a-13a, and "the mere breach of a fiduciary obligation, without misrepresentation or nondisclosure, is not deception within the meaning of § 10(b)," *id.* at 13a.

The court also concluded that the misappropriation theory conflicts with Section 10(b)'s requirement that the fraud be employed "in connection with the purchase or sale of any security." According to the court, the misappropriation theory "permits liability for a breach of a duty owed to individuals who are

unconnected to and perhaps uninterested in a securities transaction, thus rendering meaningless the 'in connection with . . .' statutory language." App. 13a. Since, the court noted, "the principal concern of section 10(b) is the protection of purchasers and sellers of securities," it concluded that "only a breach of a duty to parties to the securities transaction, or, at the most, to other market participants such as investors, will be sufficient to give rise to § 10(b) liability." *Id.* at 13a-14a.

b. The court of appeals also reversed respondent's convictions for improper trading in connection with a tender offer, under Section 14(e) and Rule 14e-3(a). It held that the SEC exceeded its rulemaking authority under Section 14(e) when it promulgated Rule 14e-3(a), which prohibits specified persons from trading while in possession of material, confidential information relating to a tender offer, unless that information is first publicly disclosed to the market. App. 24a-36a. It rejected decisions of the Second, Seventh, and Tenth Circuits upholding Rule 14e-3(a). See App. 26a-27a.

The court observed that Section 14(e) empowers the SEC to "define" and "prescribe means reasonably designed to prevent" "acts and practices" which are "fraudulent." App. 28a. It held, however, that, notwithstanding the statute's grant of authority to the SEC to "define" acts that are fraudulent, Section 14(e) does not authorize the SEC to define, as a "fraudulent" act or practice, the nondisclosure of information, without the requirement of a breach of a fiduciary duty. The court concluded that "the enabling provision of § 14(e) permits the SEC to identify and regulate those 'acts and practices' which fall within the § 14(e) legal definition of 'fraudulent,' but it

does not grant the SEC a license to redefine the term." App. 28a-29a. The court also concluded that the SEC's additional authority under the statute "to prescribe means reasonably designed to prevent" fraudulent acts was of no significance; "this provision means simply that the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of an administrative rule." *Id.* at 35a.

As to the meaning of "fraudulent" in Section 14(e), the court found "no indication that the term was to have a meaning different from its common legal definition." App. 29a. The court concluded "that 'fraudulent' under § 14(e) must be interpreted to require the breach of a fiduciary obligation or similar trust relationship." *Id.* at 32a. The court thus held that "the SEC exceeded its rulemaking authority under § 14(e) when it promulgated Rule 14e-3(a) without including a requirement of a breach of a fiduciary obligation." *Id.* at 36a.

c. Based on its reversal of the securities fraud convictions, the court of appeals also reversed respondent's mail fraud convictions under 18 U.S.C. 1341. App. 36a-37a. It noted that "[t]he mere fact that [respondent's] securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed." *Id.* at 36a. In the court's view, however, "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." *Id.* at 37a. "Because [respondent's] conduct did not constitute securities

fraud," the court reasoned that "there was no fraud upon which to base the mail fraud charges." *Ibid.*[3]

d. Judge Fagg dissented. App. 38a-39a. He pointed out that four circuits had upheld the misappropriation theory of securities fraud under Section 10(b) of the Exchange Act and Rule 10b-5. App. 38a. He also noted that the three circuits had held that the SEC did not exceed its rulemaking authority under Section 14(e) of the Exchange Act when it promulgated Rule 14e-3(a) without the requirement of a breach of a fiduciary duty. App. 38a. Adopting the views of those other circuits, Judge Fagg would have affirmed respondent's convictions on all 57 counts. *Id.* at 38a-39a.

REASONS FOR GRANTING THE PETITION

The court of appeals has rendered three major holdings that critically weaken the government's ability to prosecute the misuse of material, nonpublic information in the securities markets. First, the court held that the misappropriation theory of insider trading is an impermissible basis for imposing liability under Section 10(b) of the Exchange Act and Rule 10b-5. Second, the court held that the SEC exceeded its rulemaking authority under Section 14(e) of the Exchange Act in promulgating Rule 14e-3, a rule designed to prevent improper use of nonpublic information in the tender offer context. Third, the court of appeals held that respondent's scheme to misuse

[3] The court also overturned respondent's conviction for engaging in a monetary transaction in property derived from an unlawful activity under 18 U.S.C. 1957, and his convictions for money laundering under 18 U.S.C. 1956(a)(1)(B)(i), because "they were predicated on the securities fraud or mail fraud counts." App. 37a.

nonpublic information in breach of his fiduciary duties for the purpose of trading in securities did not violate the mail fraud statute. Each of those holdings is incorrect. Each conflicts with the decisions of other courts of appeals, and the holding on the mail fraud counts conflicts with a decision of this Court. Each holding also deprives the government of an important tool with which to combat the fraudulent misappropriation and misuse of information in securities trading. This Court's review is therefore warranted.

1. a. Section 10(b) of the Exchange Act prohibits the use, "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance" in violation of rules promulgated by the Commission. 15 U.S.C. 78j(b). Rule 10b-5 prohibits "*any* person" from engaging in "*any* act [or] practice" that "operates or would operate as a fraud or deceit upon *any* person" in connection with the purchase or sale of securities. 17 C.F.R. 240.10b-5 (emphasis added).

Under the so-called "classical" theory of insider trading liability, it is a violation of Section 10(b) and Rule 10b-5 for a person who owes a fiduciary or similar duty of trust and confidence to the shareholders of a corporation to trade in the securities of that corporation with material, nonpublic information of the corporation. See *Dirks* v. *SEC*, 463 U.S. 646, 653-654 (1983); *Chiarella* v. *United States*, 445 U.S. 222 (1980). The classical theory, however, does not reach persons who trade on misappropriated information in the securities of companies to which they do *not* owe such a duty. That situation commonly arises when (as in this case) someone misappropriates information about a planned takeover of a target company by another

company to which he owes a fiduciary duty, and then trades in the securities of the target company. In the absence of a fiduciary or similar duty of trust and confidence to the target company's shareholders, the person's trading is not a fraud on the shareholders with whom the person trades. See *Chiarella*, 445 U.S. at 232-235 (financial printer who misappropriated information about upcoming takeovers and traded in the target companies' stock not liable for fraud on those investors).

Nonetheless, in such a situation, the misuse of the confidential information does harm the entity to which that person owes a fiduciary duty (such as the company planning the takeover or the law firm acting for it). The misuse of the information interferes with the right of the company or law firm to control its use. Moreover, the trading on the misappropriated information can drive up the price of the shares of the target company, making it more expensive for the bidding company to acquire those shares. The misappropriation theory fills the gap in protection left by the "classical" theory. It provides that a person who misappropriates material, nonpublic information, in breach of a fiduciary or similar duty of trust and confidence, and trades in the security on that information, violates Section 10(b) and Rule 10b-5. See, *e.g.*, *SEC* v. *Cherif*, 933 F.2d 403 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992).

b. The court of appeals gave two reasons for rejecting the misappropriation theory, each of which is erroneous. First, the court of appeals suggested that the misappropriation theory is invalid because it does not require "deception," as the language of Section 10(b) demands, but rests instead only on a breach of fiduciary duty. App. 11a-13a. That is incorrect.

A person who misappropriates information in breach of a fiduciary duty necessarily commits deception. The fiduciary, while maintaining a pretense of loyalty, in fact uses his privileged position of trust and confidence to exploit the principal's confidential information for personal gain. The law has long recognized that this form of misconduct is a "deceptive practice" that constitutes fraud. See *Carpenter* v. *United States*, 484 U.S. 19, 27-28 (1987) (holding that such misappropriation of information by a fiduciary violates the mail fraud statute).

Second, the court of appeals concluded that any fraud in a misappropriation case is not "in connection with the purchase or sale of securities," as required by Section 10(b). App. 13-17a. The fraud in a misappropriation case, however, is directly linked to the *misappropriator's* purchase or sale of securities; indeed, the information has value to that person only because it permits him "to reap instant no-risk profits in the stock market." *SEC* v. *Materia*, 745 F.2d 197, 203 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985). A violation is established under the misappropriation theory only if the misappropriator (or his tippee) trades in securities. The trading on the misappropriated information establishes that the fraud is committed "in connection with" the purchase or sale of securities.

The court of appeals suggested, however, that Section 10(b) is intended principally to protect the purchasers and sellers of securities, and that the misappropriation theory therefore improperly extends Section 10(b) beyond the protection of market participants. App. 15a-16a. The proscription against fraud in Section 10(b), however, is not textually limited to fraud on market participants; there is no textual basis

for excluding from the statute's scope fraud practiced on the source of confidential information used for securities trading. And in any event, this case does not present the difficulty perceived by the court of appeals, for the facts of this case involve misappropriation of information about an upcoming takeover from the bidder and a law firm retained to represent it. The proper functioning of the securities markets requires that the bidder, who is indeed poised to be a "market participant," be protected against the fraudulent use of its confidential business plans. The same protection against fraud is needed for the law firms and investment advisers who represent and counsel bidders in upcoming transactions, who are privy to their confidential information because they are assisting bidders in their planned participation in the securities markets, and who are necessary to that market participation, especially in tender offers.

c. The court of appeals' holding deepens a conflict in the circuits over the validity of the misappropriation theory. Until 1995, that theory had been upheld by all of the courts of appeals that had considered it. The Second Circuit was the first to embrace the theory. In *United States* v. *Newman*, 664 F.2d 12, 17 (1981), cert. denied, 464 U.S. 863 (1983), employees of investment bankers who had been retained by bidders conspired to trade in the securities of the bidder's takeover targets. The court of appeals upheld convictions under Section 10(b) and Rule 10b-5, explaining that the "deceitful misappropriation of confidential information by a fiduciary" constituted fraud in connection with the purchase of shares in the target companies. 664 F.2d at 17. In *SEC* v. *Materia*, a case in which a financial printer had misappropriated confidential information from his employer about

upcoming tender offer targets, the court upheld liability under Section 10(b) and Rule 10b-5, stating that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5." 745 F.2d at 203. The theory has since been upheld in *SEC* v. *Cherif*, 933 F.2d at 410 ("[A] person violates Rule 10b-5 and Section 10(b) * * * by misappropriating and trading upon material information entrusted to him by virtue of a fiduciary relationship such as employment."), and *SEC* v. *Clark*, 915 F.2d 439, 453 (9th Cir. 1990) ("[A]n employee's knowing misappropriation and use of his employer's material nonpublic information regarding its intention to acquire another firm constitutes a violation of § 10(b) and Rule 10b-5."); see also *Rothberg* v. *Rosenbloom*, 771 F.2d 818, 822 (3d Cir. 1985) ("An insider on either side of a proposed transaction violates the insider trading rule when he uses insider information in violation of the fiduciary duty owed to the corporation to which he owes a duty of confidentiality."), cert. denied, 481 U.S. 1017 (1987).

In *United States* v. *Bryan*, 58 F.3d 933 (1995), the Fourth Circuit broke with that line of authority. The Fourth Circuit rejected the misappropriation theory because (it believed) that theory requires only a breach of fiduciary duty, not deception, and it covers alleged frauds that are not "in connection with" the purchase or sale of securities, at least where the victim is not an actual or prospective market participant. *Id.* at 949-952. The Eighth Circuit in this case explicitly followed *Bryan*'s analysis. App. 18a. The Eighth Circuit also acknowledged the circuit conflict, noting that "we respectfully decline to follow the

holdings of sister circuits which have adopted the misappropriation theory." *Id.* at 22a.

In *Chiarella*, although the government relied on the misappropriation theory, this Court did not reach the issue because the jury had not been instructed on that theory of liability. 445 U.S. at 235-236. Four members of the Court, however, expressed support for the theory. See *id.* at 239 (Brennan, J., concurring); *id.* at 245 (Burger, C.J., dissenting) (Chiarella "misappropriated—stole to put it bluntly—valuable nonpublic information" and then "exploited his ill-gotten informational advantage by purchasing securities in the market"); *id.* at 245 (Blackmun & Marshall, JJ., dissenting). In *Carpenter*, the Court was equally divided on the validity of the misappropriation theory as applied to a reporter's fraudulent use of confidential information owned by his newspaper about upcoming columns for the purpose of trading in the securities of companies to be discussed in the columns. 484 U.S. at 24.

The misappropriation question is important to the proper construction of Section 10(b) and Rule 10b-5, the courts of appeals are divided on the question, and the issue is squarely presented in this case. This Court's resolution of the issue is therefore warranted.

2. The court of appeals also erroneously invalidated Rule 14e-3, promulgated by the SEC under its rulemaking authority in Section 14(e) of the Act. That holding conflicts with decisions of three other courts of appeals.

a. Section 14(e) makes it unlawful for any person, *inter alia*, "to engage in any fraudulent, deceptive, or manipulative acts or practices" in connection with a tender offer. 15 U.S.C. 78n(e). Through two separate

grants of rulemaking authority, Section 14(e) empowers the Commission to (a) "define * * * such acts and practices as are fraudulent, deceptive or manipulative" and (b) "prescribe means reasonably designed to prevent[] such acts and practices." The Commission promulgated Rule 14e-3 under its Section 14(e) rulemaking authority. Rule 14e-3(a) prohibits the purchase or sale of a security after a substantial step has been taken to commence a tender offer when the purchaser or seller knows that he is in possession of material, nonpublic information relating to the tender offer acquired directly or indirectly from the offeror, the issuer, or anyone acting on behalf of either.

Rule 14e-3 responds to the fact that tender offers present significant opportunities for insider trading abuse because "even a hint of an upcoming tender offer may send the price of the target company's stock soaring." *Materia*, 745 F.2d at 199. The prospect of virtually risk-free profits may tempt persons with access to material, nonpublic information to trade before that information becomes public. To protect against the improper exploitation of such information, Rule 14e-3(a) proscribes trading while in possession of material, nonpublic information in the tender offer context, without requiring a showing that the trading breaches a fiduciary duty. While trading on such information most often will involve a breach of a duty of confidentiality to the bidder or target company, or to persons representing either party, the difficulties of establishing such a breach may permit sophisticated insider trading to go unredressed. Rule 14e-3(a) avoids that problem by flatly proscribing a class of securities transactions in which the likelihood that such a breach of duty has occurred is great. The

SEC's promulgation of this "legislative regulation[]" is entitled to "controlling weight," unless the rule is "arbitrary, capricious, or manifestly contrary to the statute." *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-844 (1984).

The court of appeals found neither of the two grants of rulemaking authority in Section 14(e) sufficient to sustain Rule 14e-3(a). App. 28a-36a. First, the court believed that the SEC is not empowered by Section 14(e) to define as a "fraudulent" act or practice a course of conduct that does not already fit within the independent proscription of "fraudulent" or "deceptive" acts or practices in the first sentence of Section 14(e). But Section 14(e)'s delegation of rulemaking authority to the SEC to "define" fraudulent acts or practices would be a virtual nullity if the SEC were limited to duplicating the coverage of Section 14(e)'s independent proscriptions. Instead, as this Court has recognized, the SEC's definitional authority affords "a mechanism for defining * * * those acts and practices which involve material misrepresentation or nondisclosure" in the tender offer context. *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1, 11 n.11 (1985). Contrary to the court of appeals' reasoning, the Commission was well within its authority to define a specific act or practice as fraudulent in the tender offer setting without requiring "the breach of a fiduciary obligation or similar trust relationship." App. 32a.

Second, the court of appeals also concluded that Rule 14e-3(a) could not be sustained as a "means reasonably designed to prevent" fraudulent acts or practices, because (it believed) the Commission's powers are limited to regulating fraud as defined in the statute. App. 33a-34a. This Court has noted, however,

that Section 14(e) gives the Commission "latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts." *Schreiber*, 472 U.S. at 11 n.11. By establishing a bright-line rule proscribing the exploitation of nonpublic information about tender offers, Rule 14e-3 serves to prevent fraudulent misuses of that information.

b. Until the decision in this case, all of the courts of appeals that had addressed the issue had found Rule 14e-3 to be valid. In *United States* v. *Chestman*, 947 F.2d 551 (1991) (en banc), cert. denied, 503 U.S. 1004 (1992), the Second Circuit, in upholding Rule 14e-3, concluded that the SEC's rulemaking authority to define fraudulent practices could not be cabined by "common law" concepts of fraud without rendering the statute's rulemaking grant "superfluous." 947 F.2d at 558. The court of appeals also found Rule 14e-3 valid as a means "reasonably designed to prevent fraud" because that grant of rulemaking authority necessarily "encompasses the power to proscribe conduct outside the purview of fraud, be it common law or SEC-defined fraud." *Ibid.* (internal quotation marks ommitted). The Tenth and the Seventh Circuits have similarly upheld Rule 14e-3. See *SEC* v. *Maio*, 51 F.3d 623, 635 (7th Cir. 1995) ("Rule 14e-3 is clearly within the SEC's statutory grant of authority to 'prescribe means reasonably designed to prevent . . . such acts and practices as are fraudulent, deceptive, or manipulative.'"); *SEC* v. *Peters*, 978 F.2d 1162, 1167 (10th Cir. 1992) ("In order effectively to prevent people from fraudulently trading on insider information obtained or used in breach of a fiduciary duty, the SEC may appropriately promulgate the fairly broad proscriptions in Rule 14e as a

prophylactic measure. * * * [I]n the tender offer context, Rule 14e-3 is consistent with the SEC's explicit and broad rulemaking authority under Section 14(e).").

The court of appeals in this case acknowledged that, in invalidating Rule 14e-3, it "must depart from the holdings of our sister circuits." App. 27a. This Court's review is warranted to resolve the conflict among the courts of appeals on this important issue of securities law.

3. The court of appeals erred further in reversing respondent's mail fraud convictions. The court acknowledged that, under this Court's decision in *Carpenter* v. *United States*, 484 U.S. 19 (1987), "[t]he mere fact that [respondent's] securities convictions have been reversed does not as a matter of law require that the mail fraud convictions likewise be reversed." App. 36a. It nonetheless concluded that the mail fraud convictions could not stand because (it believed) "the indictment was structured in such a manner as to premise the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." *Id.* at 37a. "Because [respondent's] conduct did not constitute securities fraud," the court reasoned, "there was no fraud upon which to base the mail fraud charges." *Ibid.* The court of appeals' reversal of the mail fraud convictions cannot be reconciled with *Carpenter*. The decision also reflects a misunderstanding of the way in which mail fraud cases (including this case) are prosecuted.

In *Carpenter*, a *Wall Street Journal* reporter who traded stock in anticipation of the publication of his *Journal* column, which often had an effect on the market price of stocks discussed in it, was convicted of securities fraud as well as mail and wire fraud. The

Court noted that the same "appropriation of confidential information [owned by the *Journal*] * * * underlay both the securities laws and mail and wire fraud counts." 484 U.S. at 24. Although the Court was evenly divided with respect to the convictions under the securities laws, it unanimously affirmed the mail and wire fraud convictions. *Ibid.* The Court ruled that an employee's misappropriation of confidential business information from his employer, in breach of his fiduciary obligation to that employer, falls within the scope of the mail fraud statute. *Id.* at 25-28.

Carpenter establishes that a person who misappropriates confidential business information in breach of a fiduciary duty and then trades on it in the stock market has engaged in a scheme to defraud within the mail fraud statute, whether or not the identical conduct violates the securities laws. Contrary to the court of appeals' decision in this case, therefore, a defendant may be punished for mail fraud even if the indictment "premise[s] the fraud for the mail fraud charges on the acts allegedly constituting the securities fraud." See App. 37a; pp. 9-10, *supra*. The Fourth Circuit, following *Carpenter*, has recognized that point in two related cases in which it upheld the defendants' mail fraud convictions even while reversing their securities fraud convictions, based on the same acts, in light of its rejection of the misappropriation theory of liability under Section 10(b) and Rule 10b-5. See *United States* v. *Bryan*, 58 F.3d at 943, 945; *United States* v. *ReBrook*, 58 F.3d 961, 966-967 (4th Cir.), cert. denied, 116 S. Ct. 431 (1995).

The court of appeals suggested that, because respondent's conduct did not constitute securities fraud, "there was no fraud upon which to base the mail

fraud charges." App. 37a. The court may have believed that respondent was charged with committing mail fraud by using the mails to commit violations of Section 10(b) and 14(e). That is not how the indictment was framed, however, and the mail fraud counts were not dependent on the securities fraud counts. Nor, in indictments charging both mail fraud and securities fraud violations, are the mail fraud counts made dependent on the securities fraud charges in such a manner. The mail fraud statute "reach[es] any scheme to deprive another of money or property by means of false of fraudulent pretenses, representatives, or promises," *Carpenter*, 484 U.S. at 27, and the elements of that offense are "(1) a scheme to defraud, and (2) the mailing of a letter, etc., for the purpose of executing the scheme," *Pereira* v. *United States*, 347 U.S. 1, 8 (1954). The scheme to defraud need not also be shown to be illegal under a separate provision of law, such as Section 10(b). "[T]he two crimes are distinct and require the government to prove different elements in order to secure a conviction." *ReBrook*, 58 F.3d at 967.

While, in this case, the conduct that constituted the charged scheme to defraud was essentially the same for purposes of both the securities and mail fraud counts, the mail fraud counts did not charge, as an element, that respondent had violated the securities laws. Further, the trial court instructed the jury on the mail fraud counts separately and independently of the securities fraud counts, and gave the jury no indication that proof of a mail fraud violation was dependent on proof of a securities law violation. See XII Tr. 21-24. Accordingly, respondent's conviction on the mail fraud count was not dependent on a finding that he violated the securities laws, and whether or

not his misappropriation of confidential information about Grand Met's takeover plans violated the securities laws, his misappropriation of that confidential information in breach of his fiduciary duties to Grand Met and his law firm amounted to mail fraud.

4. The court of appeals' rulings in this case have significant ramifications for the government's ability to prosecute insider trading crimes and for the Commission's ability to enforce the federal securities laws. The misappropriation theory has been a central tool in combatting insider trading involving the misappropriation of confidential information. By freeing that form of misconduct from federal regulation, the court of appeals' decision has opened a large loophole in the protections against fraud afforded by federal law.

The misappropriation theory under Section 10(b) and the prohibitions contained in Rule 14e-3 have been successfully deployed against the misuse of inside information in a wide variety of cases. See, *e.g.*, *SEC* v. *Materia*, Fed. Sec. L. Rep. (CCH) ¶ 99,526 (S.D.N.Y. 1983), aff'd, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985); *United States* v. *Marcus Schloss & Co.*, 710 F. Supp. 944 (S.D.N.Y. 1989); *SEC* v. *Vaskevitch*, 657 F. Supp. 312 (S.D.N.Y. 1987); *SEC* v. *Musella*, 578 F. Supp. 425 (S.D.N.Y. 1984); *SEC* v. *Tome*, 638 F. Supp. 596 (S.D.N.Y. 1986), aff'd, 833 F.2d 1086 (2d Cir. 1987), cert. denied, 486 U.S. 1014 (1988); *SEC* v. *Boesky*, Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. 1986) (consent judgment); *SEC* v. *Levine*, No. 86 Civ. 3726 (S.D.N.Y. 1986) (consent judgment); *SEC* v. *Drexel Burnham Lambert*, Fed. Sec. L. Rep. (CCH) ¶ 94,474 (S.D.N.Y. 1990) (consent judgment); *SEC* v. *Milken*, Fed. Sec. L. Rep. (CCH) ¶ 95,200

(S.D.N.Y. 1990) (consent judgment). The mail fraud statute has likewise been used effectively to prosecute fraudulent conduct involving the misuse of confidential information in securities trading by a variety of persons with access to such information. See, *e.g.*, *Carpenter* v. *United States*, *supra* (journalist); *United States* v. *Newman*, *supra* (tippee of investment bankers); *United States* v. *Grossman*, 843 F.2d 78, 85-86 (2d Cir. 1988) (attorney), cert. denied, 488 U.S. 1040 (1989).

By casting a cloud on the validity of those important theories of liability, the court of appeals' decision impairs the government's ability to ensure the maintenance of honest securities markets. Investor confidence in the honesty of this Nation's securities markets can only be undermined by the knowledge that trading in securities on misappropriated information is beyond the reach of federal law. That concern is heightened when the deceptive breach of fiduciary duty is that of an attorney, whose professional obligation to protect his client's confidences is essential. The circuit conflicts raised by the decision in this case thus warrant this Court's review.

CONCLUSION

The petition for a writ of certiorari should be granted.

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